PÖYRY

PÖYRY POINT OF VIEW - NOVEMBER 2015

What pain relief can be given to declining paper markets?

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Will closing the least competitive plants bring any relief to the industry, or is a strategic market consolidation approach needed?

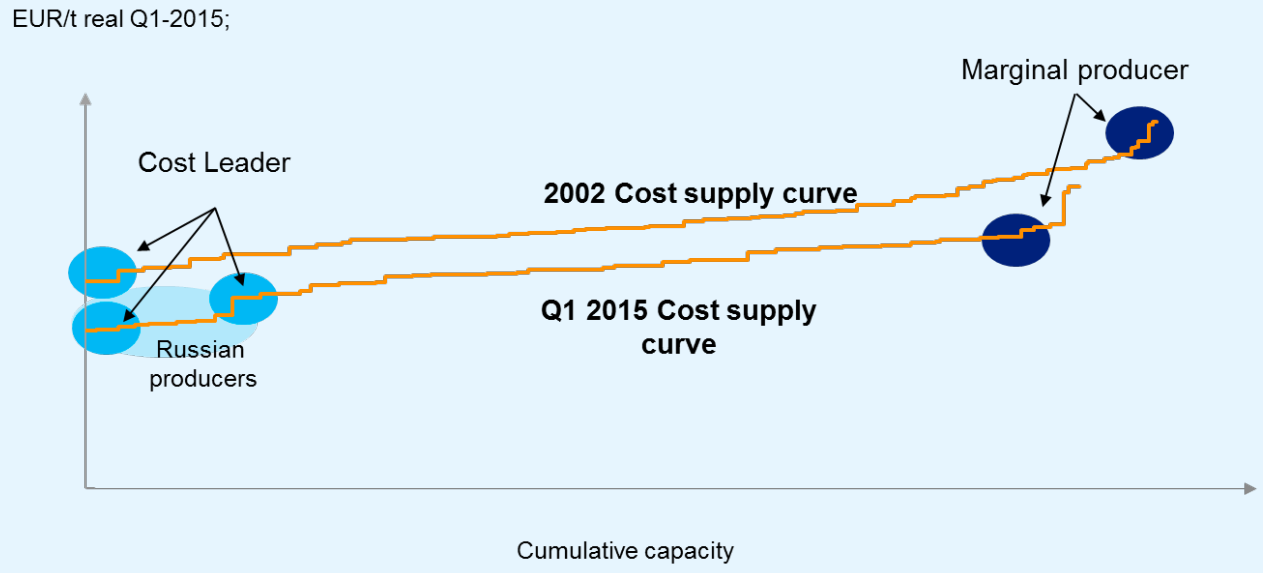
CURRENT SITUATION IN THE NEWSPRINT INDUSTRY

The graphic paper industry, and newsprint in particular, has never really recovered from the recession of 2001-2002, as we have already featured in a previous point of view. In Europe, more than 20% of the total capacity was shut down between 2008 and 2014. In the first quarter of 2015, further shutdowns have been carried out by Aylesford (Aylesford, UK) and UPM (Shotton, UK) equating to 650,000 tonnes of annual capacity. Despite these shutdowns, overcapacities remain in the market and prices have reached a historic low of around 450 EUR/t and some even below – before rebates. **At this price level even cost leaders are not able to cover their capital costs**.

Market players hope that capacity reductions will help to stabilise prices, always wishing it to be a competitor and not themselves. However, Pöyry forecasts further demand reductions of approximately 3 million tonnes by 2025 – a deep cut to the industry.

The question then is would closing the least competitive plants bring any relief or is a strategic market consolidation approach needed? In this Point of View, we examine if it is possible to actively change the future of paper pricing through a strategic acquisition and consolidation strategy. Without this, the market will continue to decline with no single paper producer profiting.

FIGURE 1: REAL DELIVERED PRICES STANDARD NEWSPRINT - EUROPE



EACH HORIZONTAL LINE EQUALS ONE MACHINE AND ITS PRODUCTION COSTS. PRODUCERS HAVE BEEN SORTED SO THAT THE LOWEST COST PRODUCERS ARE AT THE LEFT SIDE AND THE PRODUCERS WITH THE HIGHEST PRODUCTION COSTS AT THE RIGHT SIDE

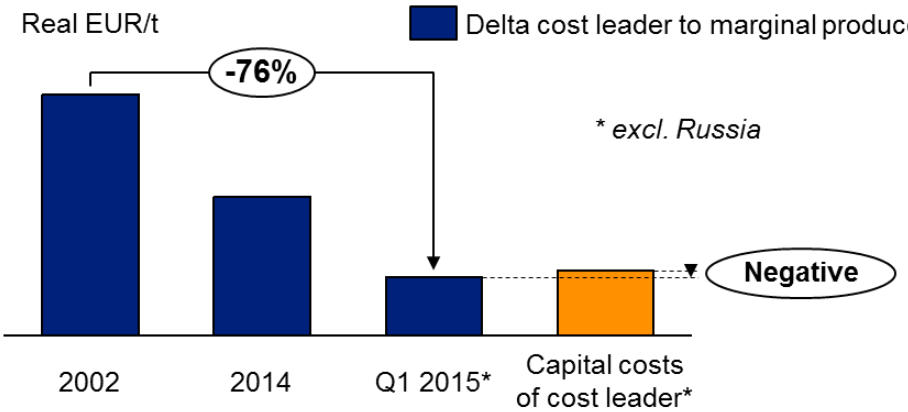
Only strategically steered closings are able to improve the pricing situation

RECENTLY, SHUTDOWNS OF THE LEAST COMPETITIVE PLANTS HAVE FLATTENED AND LOWERED THE COST SUPPLY CURVE AND THEREBY LOWERED THE PRICE FOR PAPER

The historic development in the newsprint industry follows classic economic theory – over time the supply curve flattens out[1]. Figure 1 shows the supply curves for 2002 and 2014 for the capacity and respective production costs of a single paper machine. Capacity reductions and cost saving measures over time can be seen through the flattening of the curve in q1 2015 as economic theory would suggest. The marginal producer has moved downwards – and thereby led to the decline of newsprint prices.

That the curve has flattened can be observed when the delta between cost leaders and the marginal producers is analysed (figure 2). Since 2002 this difference has dropped significantly and is now 76% below its original level. Exactly this margin is typically used to cover capital costs. **In today's world, not even the cost leaders in european newsprint paper are able to cover their capital costs**.

FIGURE 2: DELTA COST LEADER VS. MARGINAL PRODUCER



CLOSING OF THE LEAST COMPETITIVE PLANTS WILL DETERIORATE THE SITUATION WHEREAS STRATEGIC CLOSINGS HELP TO STABILISE AND EVEN INCREASE PRICES

Since the recession of 2002, the least competitive producers have dropped out of the market. This trend also applies to today where closing the least competitive plants would be the natural path for the industry to follow. However, an alternative approach is a strategically motivated, controlled exit of plants in the 'midfield' of the supply curves (figure 3). The same amount of capacity exits the market in both cases– but the effect is different.

In the case of closing the least competitive plants the supply curve flattens, but in the case of 'midfield closures' the slope of the curve increases. **As a consequence**, **prices also increase**[2] (figure 3, step 2).

Let's take a fictitious company with four paper machines (PMs) and analyse the impact of closures on the overall contribution margin. As can be seen in figure 3, step 3, total contribution margin increases by 140% in the 'midfield' scenario compared to the closure of the least competitive plants. Why does it pay off to close low cost assets and keep high cost assets running?

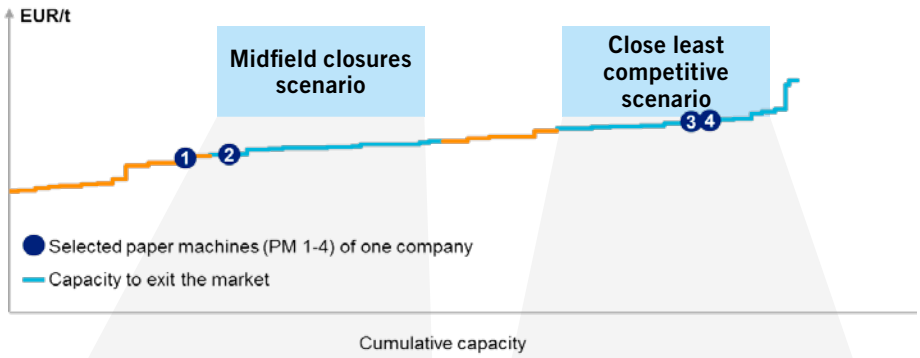
The cost situation of individual machines has not changed but in the "midfield" scenario the product price is higher. Thus PM1 is highly profitable and PM3 and PM4 are also cash flow positive.

In the second scenario the individual machines have the same production costs as in the 'midfield' scenario but the product price is lower. Thus, from a margin perspective, the highly efficient machines PM1 and PM2 are not performing.

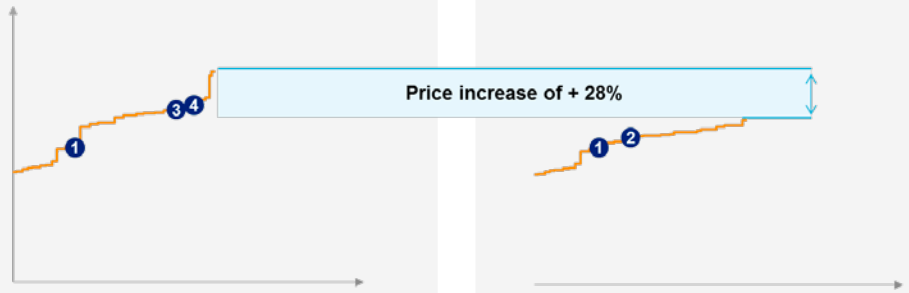
Closing is always the last option and has associated costs. But the present situation is clear – some plants must exit the market. Contribution margin analysis shows that it is far more favourable to follow the scenario of midfield closures[3]. Costs remain constant but prices and thus also contribution margins are significantly higher in this scenario.

FIGURE 3: WHERE SHOULD CAPACITY REDUCTIONS TAKE PLACE?

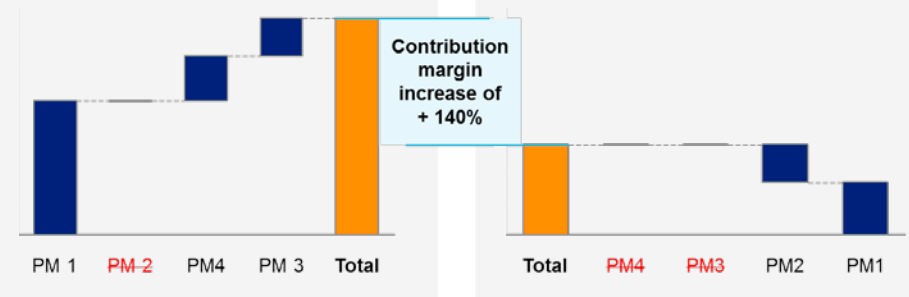
Step 1: Two main scenario options for closures exist in a market with declining demand.



Step 2: The 'midfield' closure scenario results in an increased market price as the position of the marginal producer changes (assuming same amount of closures and inflexible demand).

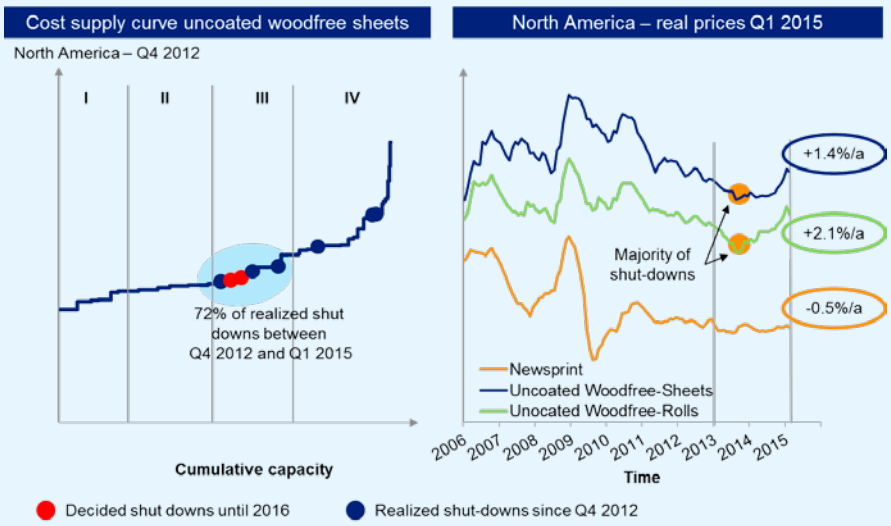


Step 3: Contribution margins are higher in the midfield scenario as costs remain constant and only price changes



Since the recession of 2002, the least competitive producers have dropped out of the market

FIGURE 4: PRICE INCREASES IN UWF AFTER MIDFIELD CLOSURES

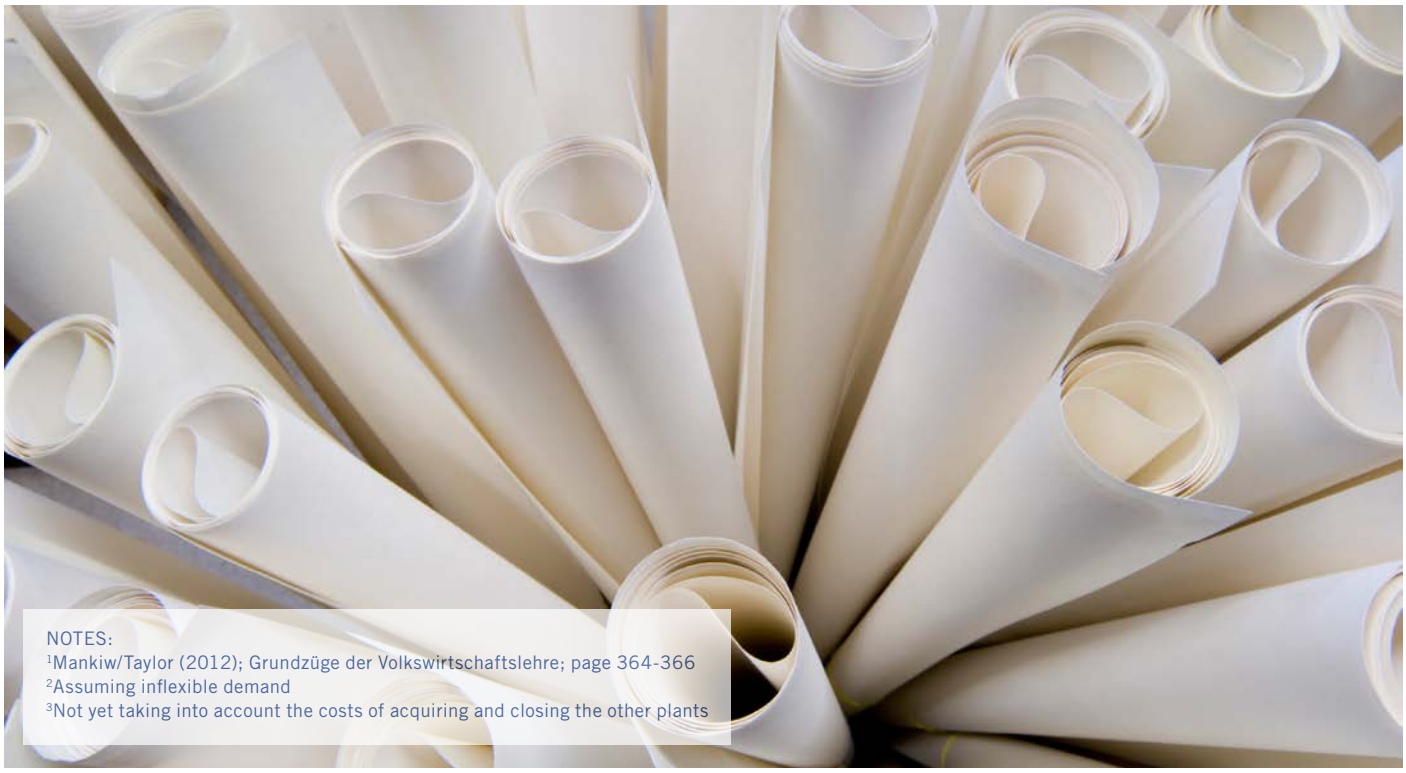


US MARKET DEVELOPMENT IN UNCOATED WOODFREE (UWF) PAPERS

The positive impact of midfield closures can be observed in other markets and grades. The market for uncoated woodfree papers has declined from 11.1 million tonnes in 2009 to 8.6 million tonnes in 2013. However, Figure 4 illustrates how the majority of capacity is being closed in the third quartile leading to a slightly flattened cost curve despite capacity reductions. At the time of going to press, capacity reductions recently announced will also be from this section of the graph.

In same time period (Q4 2012 to Q1 2015) prices for uncoated woodfree papers have stabilised and even increased. This is a major difference to newsprint industries in North America where capacity was reducing in comparable magnitude but prices have at best stabilised.

Where closed plants are positioned on the cost supply curve does make a difference to the bottom line.

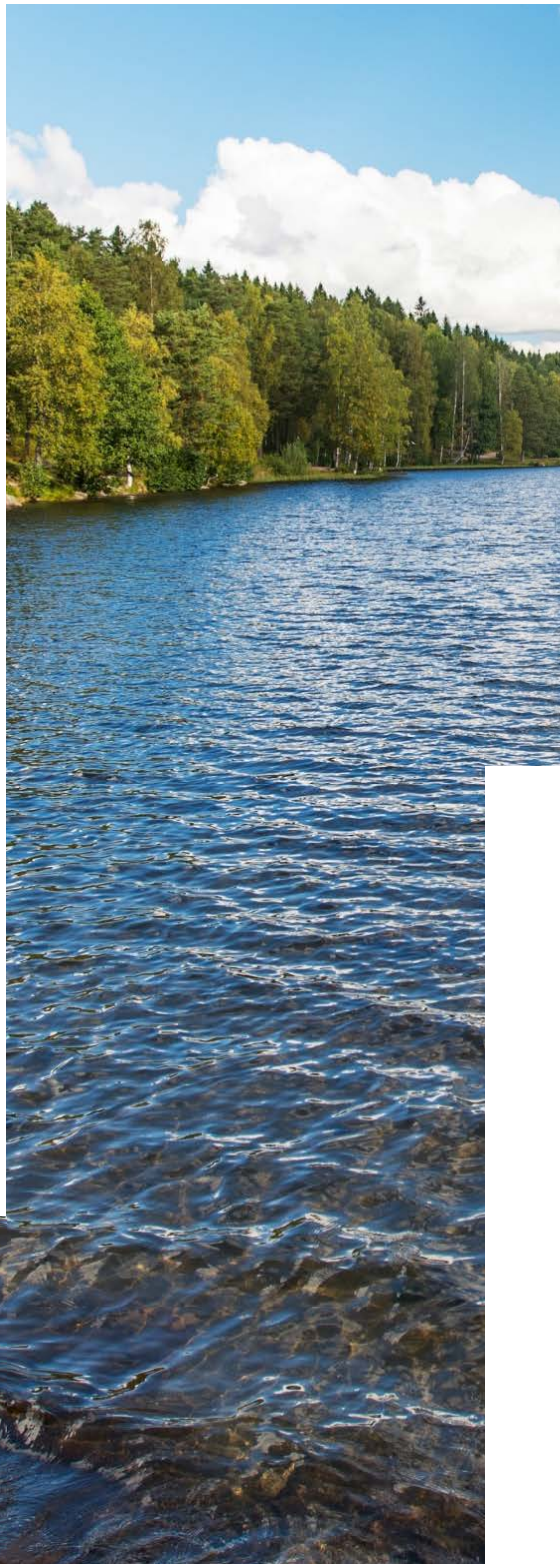


NOTES:
[1]Mankiw/Taylor (2012); Grundzüge der Volkswirtschaftslehre; page 364-366
[2]Assuming inflexible demand
[3]Not yet taking into account the costs of acquiring and closing the other plants

Future market development requires a strategic assessment

We have shown that it is possible to actively change the future of paper pricing by shaping the supply curve. But without a strategic acquisition and consolidation strategy the market will continue to decline with no single paper producer profiting. Declining markets have inherent losers, but allow for winners with significantly greater profit margins if proper strategy is applied.

This industry perspective is also true for individual corporations but heavily depends on the individual asset positioning. Future market development requires a strategic assessment. This includes having a view on future market circumstances and accounting for where on the supply curve the group's paper machines are positioned, which plants should be selected for closure and the impact on overall strategy and cash flow requirements. Inaction instead will allow market forces to further depress prices and challenge the viability of every company's operations.



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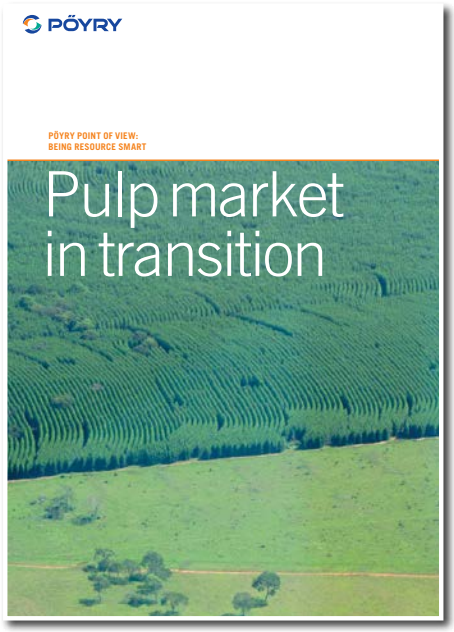

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